11.05 Sale-leaseback Transactions

Overview

A **sale-leaseback transaction** occurs when the property owner sells the property, then immediately leases all or part of it back from the new owner. Most of the time a company does a sale-leaseback to raise cash. This transaction is accounted for in one of two ways:

- **As a sale (with gain or loss) + an operating lease** – if normal revenue recognition conditions are met and the lease portion meets none of the Special-PO-T-75-90 criteria.
- **As no sale, just a loan** – if the lease portion meets **at least one** of the Special-PO-T-75-90 criteria, indicating the property owner sold the property then essentially bought it back, meaning no genuine sale to an external party occurred.
  - In this situation, where the leaseback would qualify as a finance lease, the accounting is simple:
    - The asset remains on the seller-lessee's books.
    - No sale or gain (loss) is recorded.
    - No lease accounting is applied.
    - The transaction is accounted for as a Note Payable.

Loan Example

Candy Co. needs cash. On December 31, Year 1, Candy Co. sells a building with an adjusted basis of $80,000 and a fair value of $100,000 to Kahuna Co. for $100,000 at 10% interest rate, then immediately leases back the building from Kahuna Co. The PV of the lease payments totals $100,000 and the title transfers back to Candy at the end of the lease term. The first lease payment is due December 31, Year 2.

In this situation, Candy didn't really sell the building to Kahuna, because the leaseback terms (Special-PO-T-75-90) allow the seller-lessee, Candy, to retain substantially all the rights and risks of ownership. The transaction allowed Candy to raise a lump sum of cash—the $100,000 selling price—in exchange for paying back the $100,000 over the course of the lease term. The transaction is, in substance, a **loan**.

Assuming a 10% interest rate and yearly payments of $20,000, Candy's journal entries on the sale date and for the first payment would be:

December 31, Year 1		
Cash	100,000	
Note payable		100,000

December 31, Year 2		
Interest expense (10% × $100,000)	10,000	
Note payable (difference)	10,000	
Cash		20,000

Now, let's see how the accounting changes for a sale-leaseback that does not meet any of the five criteria (ie, the leaseback is an **operating lease**).

Operating Lease Example

On December 31, Year 1 Candy Co. sells equipment to Kahuna Co. for $10,000, then immediately leases it back. The equipment has an original cost of $12,000, a carrying value of $9,000, and a fair value of $10,000. The lease term is 10 years and requires annual payments of $1,184, starting on the sale date. The estimated remaining useful life of the equipment is 15 years. With an implicit rate of 10%, known to both parties, the PV of the lease payments is $8,000.

None of the Special-PO-T-75-90 criteria are met, so the leaseback is an operating lease. The situation is therefore considered both a sale and an operating lease, resulting in the following seller-lessee journal entries for Candy Co.:

December 31, Year 1 – to record the sale of asset		
Cash	10,000	
Accumulated depreciation	3,000	
Equipment (cost)		12,000
Gain on sale-leaseback		1,000

December 31, Year 1 – to record the operating lease		
Right-of-use asset	8,000	
Lease payable		8,000

December 31, Year 1 – to record the initial payment		
Lease payable	1,184	
Cash		1,184

This initial principal-only payment reduces the remaining lease liability to $8,000 - $1,184, or $6,816.

December 31, Year 2 – to record annual lease payment and amortization of the ROU asset		
Lease expense *	1,184	
Lease payable**	502	
Cash		1,184
Right-of-use asset		502

**Lease expense = interest exp. ($6,816 × 10%) + amortization exp. ($1,184 – $682)*

*** Lease payable reduction and ROU asset amortization = $1,184 payment – $682 interest exp.*

Lease Liability	Interest Rate	=	Interest Expense	–	Lease Payment	=	Reduction in Lease Liability
8,000							
(1,184)							
6,816	10%	=	682	–	1,184	=	502
(502)							
6,314	10%	=	631	–	1,184	=	553
(553)							
5,761							